



STATE BOARD OF EQUALIZATION STAFF LEGISLATIVE BILL ANALYSIS

DRAFT

Date:	04/10/13	Bill No:	Assembly Bill 486
Tax Program:	Sales and Use Tax	Author:	Mullin, et al.
Sponsor:	California Manufacturing and Technology Association and the Bay Area Council	Code Sections:	RTC 6377.4
Related Bills:	AB 653 (Perez, V.) AB 1326 (Gorell) SB 235 (Wyland) SB 376 (Correa) SB 412 (Knight)	Effective Date:	Upon enactment but operative January 1, 2014

BILL SUMMARY

This bill provides manufacturers, software publishers, biotechnology and other physical, engineering, and life science researchers and developers, and their affiliates, a 5.25% sales and use tax exemption for their purchases of qualifying tangible personal property.

ANALYSIS

CURRENT LAW

Except where the law provides a specific exemption or exclusion, California's Sales and Use Tax Law¹ imposes the sales tax on all retailers for the privilege of selling tangible personal property at retail in this state or the use tax on the storage, use, or other consumption in this state of tangible personal property purchased from a retailer.

Generally, sales or use tax applies to the sale or purchase of tangible personal property to persons who use the property to manufacture, produce or process tangible personal property. A manufacturer's taxable purchases include machines, tools, furniture, forklifts, generators, and office equipment. A software publisher's taxable purchases include computer equipment, such as servers, routers, switches, power units, network devices, hard drives, processors, memory modules, and other computer hardware and components. An electric power generating facility's taxable purchases include transformers, alternators, generators, transmitters, turbines and solar panels. A biotechnology researcher's taxable purchases include various lab tools, workstations, monitors, and analyzers.

Conversely, tax does not apply to sales of tangible personal property when the purchasers physically incorporate that property into the manufactured article to be sold. For example, no tax applies to a manufacturer's raw material purchases when, prior to making a taxable use, they become an ingredient or component part of the manufactured article to be resold.

California Alternative Energy and Advanced Transportation Financing Authority (CAEATFA). Existing law² contains a specific sales and use tax exclusion³ for tangible

¹ Part 1 of Division 2 (commencing with Section 6001) of the Revenue and Taxation Code (RTC).

² RTC Section 6010.8.

personal property purchased for certain approved manufacturing projects. In 2010, legislation⁴ authorized the CAEATFA to approve sales and use tax exclusions for tangible personal property utilized for the design, manufacture, production, or assembly of advanced transportation technologies or alternative energy source products, components or systems. In 2012, legislation⁵ was enacted to authorize CAEATFA to approve sales and use tax exclusions related to advanced manufacturing projects until July 1, 2016. The law⁶ provides a \$100 million cap for these exclusions.

CAEATFA's approval of these exclusions is based on whether the project results in a net benefit to the State, with consideration to both fiscal and environmental benefits.

California's sales and use tax rates. Effective January 1, 2013, California imposes a statewide 7.5% sales and use tax on tangible personal property sales and purchases. The table below shows California's various sales and use tax rate components (the table excludes voter-approved city and county district taxes):

Rate	Jurisdiction	Purpose/Authority
3.9375%	State (General Fund)	State general purposes (Revenue and Taxation Code (RTC) Sections 6051, 6051.3, 6201, and 6201.3)
1.0625%	Local Revenue Fund 2011	Realignment of local public safety services (RTC Sections 6051.15 and 6201.15)
0.25%	State (Fiscal Recovery Fund)	Repayment of the Economic Recovery Bonds (RTC Sections 6051.5 and 6201.5)
0.25%	State (Education Protection Account)	Schools and community college funding (Section 36, Article XIII, State Constitution)
0.50%	State (Local Revenue Fund)	Local governments to fund health and welfare programs (RTC Sections 6051.2 and 6201.2)
0.50%	State (Local Public Safety Fund)	Local governments to fund public safety services (Section 35, Article XIII, State Constitution)
1.00%	Local (City/County) 0.75% City and County 0.25% County	City and county general operations (RTC Section 7203.1, operative 7/1/04); Dedicated to county transportation purposes
7.50%	Total Statewide Rate	

PROPOSED LAW

Beginning January 1, 2014, this bill provides a 5.25% sales and use tax exemption for a "qualified person's" purchases of:

- Tangible personal property to be used 50% or more in manufacturing, processing, refining, fabricating, or recycling of property (i.e., machinery, equipment, parts, belts, shafts, computers, software, pollution control equipment, buildings and foundations), as specified.

³ An "exclusion" means the transfer of the property is neither a "sale" nor a "purchase" and is therefore excluded from the application of the sales and use tax. An "exemption" involves a retail sale that, absent an exemption in law, would otherwise be subject to the tax.

⁴ SB 71 (Ch. 10, Stats. 2010, effective March 24, 2010).

⁵ SB 1128 (Ch. 677, Stats. 2011, effective January 1, 2013).

⁶ Public Resources Code Section 26011.8.

This staff analysis is provided to address various administrative, cost, revenue and policy issues; it is not to be construed to reflect or suggest the BOE's formal position.

- Tangible personal property purchased by a contractor, as specified, for use in the performance of a qualified person's construction contract. The qualified person must use the property, however, as an integral part of any manufacturing, processing, refining, fabricating, or recycling process or as a research or storage facility in connection with the manufacturing process.
- Tangible personal property to be used 50% or more in research and development (R&D).

This bill defines "qualified person" as either:

- A trade or business that is primarily engaged in
 - ❖ Manufacturing activities, as described in the 2012 edition of the North American Industrial Classification System (NAICS) codes 3111 through 3399,
 - ❖ Software publishing activities as described in NAICS code 5112,
 - ❖ Biotechnology R&D, described in NAICS code 541711, and
 - ❖ Physical, engineering, and life sciences R&D, described in NAICS Code 541712.
- A qualified person's affiliate, if the affiliate is a member of that person's unitary group, as specified.

The bill defines "fabricating," "manufacturing," "primarily," "process," "processing," "refining," "research and development," and "useful life." The bill also specifies the tangible personal property included or excluded from the proposed partial exemption.

The proposed partial exemption excludes:

- Consumables with less than a one year useful life,
- Furniture, inventory, equipment used in the extraction process or equipment used to store finished products that have completed the manufacturing process, and
- Tangible personal property primarily used in administration, general management, or marketing.

The bill excludes from the exemption, any city, county, or district tax levied pursuant to the Bradley-Burns Uniform Local Sales and Use Tax Law or the Transactions and Use Tax Law. It also excludes the 0.5% Local Revenue Fund, the 0.5% Local Public Safety Fund, and the 0.25% Education Protection Account components. The proposed exemption includes the remaining state and local sales and use tax components.⁷

BACKGROUND

For a ten-year period ending December 31, 2003, the law provided new manufacturers with a state General Fund sales and use tax exemption on their purchases of specified manufacturing equipment. Also, the law provided manufacturers income and corporation tax credits (MIC) of 6% for similar equipment placed in service in California. Similar to the exemption proposed in this bill, the partial exemption and credit related to equipment used primarily for manufacturing, refining, processing, fabricating or recycling. New manufacturers could claim the partial exemption or the MIC. However, existing manufacturers could only claim the MIC.

⁷ 3.9375% General Fund, 1.0625% Local Revenue Fund 2011, 0.25% Fiscal Recovery Fund.

This partial exemption and MIC contained a conditional sunset date. The law required these provisions to sunset when manufacturing employment,⁸ less aerospace employment, failed to exceed January 1, 1994, manufacturing employment by more than 100,000. On January 1, 2003, the employment figures were less than the 1994 number by over 10,000. Therefore, the partial exemption and MIC sunset at the end of 2003.

Legislative History. Since then, numerous bills have been introduced to reinstate, expand, or modify the exemption and/or MIC, but all failed to pass. Bills introduced during the last two Legislative sessions that exempted similar purchases from sales and use tax include:

Bill No.	Session	Author	Proposed Exemption
ABx1 40	2011-12	Allen	3.9375% exemption for new businesses and 3% for existing businesses engaged in manufacturing, software production, biotechnology research and development, and renewable power generation facilities.
AB 103	2011-12	Budget Committee	5% exemption for new manufacturers and software producers, and 1% for existing manufacturers and software producers.
AB 218	2011-12	Wieckowski	5.25% exemption for manufacturers and software producers.
AB 303	2011-12	Knight	5% exemption for new manufacturers.
AB 979	2011-12	Silva	5% exemption for manufacturers and software producers and affiliates.
AB 1057	2011-12	Olsen	5% exemption for manufacturing, research and development, and air pollution mitigation by manufacturers and affiliates.
SB 116	2011-12	Dutton	Same as ABx1 40 above.
SB 395	2011-12	Dutton	5% exemption for manufacturing and software production.
AB 1911	2011-12	Donnelly	3.9375% exemption for manufacturing and software production.
AB 1972	2011-12	Huber	Full exemption for manufacturing, software production, biotechnology research and development, and renewable power generation facilities.
SB 686	2011-12	Padilla	Full exemption for biotechnology manufacturing and research and development activities.
AB 810 and AB 829	2009-10	Caballero	5% exemption for qualifying tangible personal property, and 6% exemption for sustainable development equipment investments by manufacturing and software production.
AB 1719	2009-10	Harkey	6% exemption for manufacturing.
AB 1812	2009-10	Silva	6% exemption for manufacturing and software production.
AB 2280	2009-10	Miller	Full exemption for manufacturing.

⁸ As determined by the Employment Development Department.

Bill No.	Session	Author	Proposed Exemption
SB 1053	2009-10	Runner	6% exemption for manufacturing and software publishing and their affiliates.
SBx6 18	2009-10	Steinberg & Alquist	6% exemption for specific manufacturing and software production activities.
SBx6 8 & SBx6 44	2009-10	Dutton	6% exemption for manufacturers and software publishers and affiliates.

COMMENTS

1. Sponsor and Purpose. The California Manufacturing and Technology Association and the Bay Area Council are the bill's sponsors. According to the author, most economists who study government finance and taxation agree that business inputs (e.g., machinery, research equipment, raw materials, etc.) should be exempt from sales tax because business outputs are already subject to sales tax, and taxing both business inputs and outputs results in double taxation. The author believes the state's policy of charging a sales and use tax on manufacturing equipment is notable because it makes our state uniquely uncompetitive.

2. The bill references various NAICS codes to describe qualifying taxpayers.

NAICS codes 3111 to 3399 include all establishments primarily engaged in manufacturing activities. This includes manufacturers in the aerospace sector, textiles, pharmaceuticals, printing, food, and more.

NAICS code 5112 includes establishments primarily engaged in computer software publishing or publishing and reproduction. Software publishing establishments carry out the functions necessary for producing and distributing computer software. This includes activities such as design, documentation, installation, and support services to software purchasers. The software publishing industry produces and distributes information mostly by CD-ROMs, through the sale of new computers with preloaded software, or through the Internet.

NAICS code 541711 includes establishments primarily engaged in conducting biotechnology research and experimental development. This involves the study of the use of microorganisms and cellular and biomolecular processes to develop or alter living or non-living materials. This biotechnology R&D may result in new biotechnology processes or in new or genetically-altered product prototypes that various industries may reproduce or utilize.

NAICS code 541712 includes establishments primarily engaged in conducting research and experimental development (except biotechnology research and experimental development) in the physical, engineering, and life sciences, such as agriculture, electronics, environmental, biology, botany, computers, chemistry, food, fisheries, forests, geology, health, mathematics, medicine, oceanography, pharmacy, physics, veterinary and other allied subjects.

3. Affiliates' purchases also qualify for the proposed exemption. In addition to the entities described previously, these establishments' affiliate purchases qualify for the exemption.⁹ As proposed, the law does not require that the affiliates be engaged in particular activities. Instead, their purchases of qualifying tangible personal property

⁹ Those that are members of the entity's unitary group for which a combined report is required under Article 1 (commencing with Section 25101) of Chapter 17 of Part 11 of the RTC.

need only be for use in a manner described in the bill. For example, an affiliate of a television manufacturer may be primarily engaged in recycling. All the affiliate's equipment purchases for recycling would qualify for the proposed exemption, even if they are unrelated to television manufacturing, i.e., the activity which makes both persons "qualified persons." This is true whether or not the manufacturer operates primarily outside this state. The original manufacturing exemption discussed previously did not have this provision. Potentially, this provision adds a new level of complexity for tax administration purposes, and results in additional revenue losses not captured in this analysis.

4. Proposed exemption differs from previous exemption. As drafted, this bill does not exempt fuels used in the manufacturing, processing, refining, fabricating or recycling process. The bill also does not exempt tangible personal property purchased to measure or test qualifying tangible personal property. These purchases by qualified manufacturing establishments qualified for the previous partial exemption.

5. Partial exemptions complicate administration of the tax. Currently, most sales and use tax exemptions apply to the total applicable sales and use tax. However, California law contains five partial exemptions, currently at a 5.5%¹⁰ rate:

- (1) Farm equipment and machinery,
- (2) Diesel fuel used for farming and food processing,
- (3) Teleproduction and postproduction equipment,
- (4) Timber harvesting equipment and machinery, and
- (5) Racehorse breeding stock.

These partial tax exemptions complicate retailers' return preparation and return processing. Return errors occur frequently with claimed partial exemptions. Accordingly, the BOE's return processing workload increases.

Also, this bill proposes a new 5.25% exemption rate. This requires a sales and use tax return revision with a new, separate return computation. If enacted, some retailers may be required to segregate the 5.25% exempt sales, the 5.50% exempt sales, fully exempted sales (e.g., a resale sale or interstate commerce sale), and fully taxable sales. This adds a new level of complexity, and potentially increases tax reporting errors. Accordingly, the BOE's tax administrative functions and retailers' reporting obligations become more complicated.

6. The term "property" needs clarification. The bill exempts a qualified person's "property" purchased for use in manufacturing, fabrication, processing, etc. Manufactured "property" is generally construed to mean the traditional manufacturing of tangible items, not the creation of intangibles or the provision of services and utilities. However, the bill does not expressly limit the term to tangible personal property purchased for use in manufacturing or fabricating. Taxpayers could assert that the bill includes intangible property creation or the provision of services and utilities. To avoid any unintended consequence, we recommend the term "property" be replaced with "tangible personal property." Suggested amendments are shown on page 10.

¹⁰ 3.9375% General Fund, 1.0625% Local Revenue Fund 2011, 0.25% Fiscal Recovery Fund, and 0.25% Education Protection Account.

Related legislation. Similar bills have been introduced this year:

- **AB 653 (V. Perez)** – provides manufacturers, software publishers, biotechnology research entities, and renewable power generator facilities, and their affiliates a state and local exemption for their qualifying tangible personal property purchases.
- **AB 1326 (Gorell)** – provides unmanned aerial vehicle manufacturers a state and local exemption for their qualifying tangible personal property purchases.
- **SB 235 (Wyland)** – provides manufacturers and their affiliates a 3.9375% exemption for their qualifying tangible personal property purchases.
- **SB 376 (Correa)** – beginning January 1, 2017, provides manufacturers, software publishers, and their affiliates a 6.5% exemption for their qualifying tangible personal property. Provides an income tax credit for tax paid on similar purchases beginning January 1, 2014 through January 1, 2017.
- **SB 412 (Knight)** – provides aerospace products and parts manufacturers a 3.9375% exemption for their qualifying tangible personal property purchases.

COST ESTIMATE

A cost estimate is pending to determine costs to reprogram for the partial exemption, revise and process returns, notify retailers, audit claimed exemptions, and answer inquiries from taxpayers and the general public.

REVENUE ESTIMATE

BACKGROUND, METHODOLOGY, AND ASSUMPTIONS

NAICS 31-33 (Manufacturing). The United States Census Bureau's *Annual Survey of Manufacturers* (ASM) reports California manufacturing capital expenditures data (machines and equipment, buildings, fuels). In fiscal year (FY) 2010-11, California manufacturers' capital expenditures amounted to an estimated \$11 billion. We assume this amount includes manufacturers' research and development-related capital expenditures. This bill does not exempt fuel purchases.

NAICS 5112 (Software Publishers). The Census Bureau's *Annual Capital Expenditures Survey* (ACES) reported U.S capital expenditures data (machines and equipment, buildings) for software publishers. For California expenditures, we looked at the 2007 *Economic Census* software publishers' data and estimated that the ratio of California to U.S revenue sales receipts ratio for software publishers equals 28%. We applied the 28% to U.S capital expenditures (ACES). In FY 2010-11, California software publishers' capital expenditures amounted to an estimated \$1.4 billion.

NAICS 541711 (Biotechnology R&D). Based on ACES data and 2007 *Economic Census* data, we estimated that capital expenditures by establishments in California primarily engaged in biotechnology research and experimental development amounted to \$0.48 billion in FY 2010-11.

NAICS 541712 (Physical, Engineering & Life Sciences R&D). Based on ACES data and 2007 *Economic Census* data, we estimated that in FY 2010-11, California establishments primarily engaged in physical, engineering and life sciences R&D amounted to \$0.51 billion.

Capital Expenditures. Based on the Census data, total capital expenditures in FY 2010-11 amounted to an estimated \$13.4 billion (NAICS 31-33, \$11 billion + NAICS 5112, \$1.4 billion, NAICS 541711, \$0.48 billion, NAICS 541712, \$0.51 billion).

The partial sales and use tax exemption becomes operative January 1, 2014. To forecast expenditures from the 2010-11 data described previously, we used a national economic forecasting firm's (IHS Global Insight) most recent business equipment investment forecast. The estimated expenditures are as follows:

Capital Expenditures - California
(In billions)

	FY		
	FY 2013-14	2014-15	FY 2015-16
NAICS 31-33	\$14.05	\$15.08	\$16.12
NAICS 5112	\$1.80	\$1.93	\$2.06
NAICS 541711	\$0.61	\$0.65	\$0.70
NAICS 541712	\$0.64	\$0.69	\$0.73
	\$17.10	\$18.35	\$19.61

REVENUE SUMMARY

The annual revenue loss from exempting from the 5.25% sales and use tax for qualifying purchases used in manufacturing (NAICS 31-33), software publishing (NAICS 5112), biotechnology R&D (NAICS 541711) and physical, engineering & life sciences R&D (NAICS 541712) amounts to:

Sales & Use Tax Loss
(In Millions)

	FY 2013-14 (6 month impact)	FY 2014-15	FY 2015-16
State General Fund 3.94%	\$337	\$723	\$773
Fiscal Recovery Fund 0.25%	\$21	\$46	\$49
Local Revenue Fund 2011 1.06%	\$91	\$195	\$208
Estimated SUT Loss 5.25%	\$449	\$964	\$1,030

Qualifying Remarks. The revenue estimate is understated to the extent that the bill (1) does not limit the proposed partial exemption to establishments *primarily* engaged in manufacturing, software publishing, and qualifying R&D, and (2) the proposed partial exemption applies to affiliate purchases, as defined. Our estimate is based on those establishments that are *primarily* engaged in the qualifying activities. For the affiliate purchases, we do not have information related to the revenue loss associated with these purchases.

In addition, the revenue estimate is overstated to the extent that it does not account for manufacturing-related sales and use tax exclusions authorized by CAEATFA. The 2009 legislation has resulted in sales and use tax revenue losses of approximately \$37 million in 2010, \$4.7 million in 2011, and \$8.7 million in 2012. We have no information on exclusions related to advanced manufacturing purchases authorized by the 2012 legislation. However, the law caps the allowable sales and use tax exclusions for both programs at \$100 million annually.

This staff analysis is provided to address various administrative, cost, revenue and policy issues; it is not to be construed to reflect or suggest the BOE's formal position.

This revenue estimate does not account for any changes in economic activity that may or may not result from enactment of the proposed law.

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STATE BOARD OF EQUALIZATION
PROPOSED AMENDMENTS TO AB 486

AMENDMENT 1

On page 3, line 11, add “tangible personal” after “altered” and before “property”

AMENDMENT 2

On page 3, line 24, add “tangible personal” before “property”

AMENDMENT 3

On page 6, line 21, add “tangible personal” before “property”